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Financial market frictions and diversification[☆]

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ABSTRACT

We find new facts that relate the evolution of firm scope to the changing frictions in external capital markets over the last three decades. We find that large, diversified publicly traded firms increase their scope during times of high external capital market frictions, such as in the recent Great Recession. Moreover, during these times firms diversify their investment needs and cash flow across industries. We also find similar phenomena outside diversified public firms. Examining the mergers and acquisitions activity of stand-alone and diversified private firms, we uncover similar patterns. In aggregate data, we find that the composition of mergers shifts from focused to diversifying and back with changes in external market conditions. Our evidence is broadly consistent with the notion that firms diversify their scope in response to tightening in external capital markets.

JEL classification: D92, E22, G01, G3, L21, L25

Keywords: Theory of firm, Firm boundaries, Conglomerates, Diversification, Internal capital markets

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